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# ***IRS provides important guidance for helping taxpayers understand the impact of the final tangible property repair regulations***

*February 10, 2014*

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## ***In brief***

Rev. Proc. 2014-16, released on January 24, 2014, provides the change in method of accounting procedures for taxpayers to comply with the final tangible property regulations (final repair regulations, final regulations or repair regulations) issued on September 13, 2013.

The final repair regulations address the deduction and capitalization of amounts paid to acquire, produce or improve tangible property under Sections 162 and 263(a). These final regulations replaced and removed the temporary regulations issued on December 23, 2011 (the 2011 temporary repair regulations).

The final repair regulations are broad in scope and will affect most taxpayers that acquire, produce or improve tangible property.

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## ***In detail***

### ***Background***

The final repair regulations apply to tax years beginning on or after January 1, 2014. Although some aspects of the final regulations apply only to amounts paid or incurred in tax years beginning on or after January 1, 2014 (cut-off method), some rules in the final regulations will affect expenditures prior to January 1, 2014, and will require a Section 481(a) adjustment (cumulative adjustment).

Rev. Proc. 2014-16 provides a great deal of flexibility and a number of tax planning considerations for taxpayers. For example, taxpayers may choose to 'early adopt' the repair regulations for tax years beginning on or after January 1, 2012. Alternatively, the final repair regulations provide taxpayers with the choice of applying the 2011 temporary regulations for tax years beginning on or after January 1, 2012, and before January 1, 2014. Accordingly, all taxpayers must determine if they intend to

adopt the final or temporary repair regulations for 2012 and 2013 (the final regulations provide for transition relief for taxpayers that wish to adopt the final regulations but already have filed 2012 and 2013 Federal income tax returns). If a taxpayer wishes to adopt the accounting methods under the final or 2011 temporary repair regulations, then a Form 3115, *Application for Change in Accounting Method*, must be filed requesting permission to make the automatic accounting method changes.

### **Key aspects of Rev. Proc. 2014-16**

The effective date of Rev. Proc. 2014-16 is January 24, 2014. This revenue procedure supersedes Rev. Proc. 2012-19, and modifies Rev. Proc. 2011-14, which provides taxpayers with general procedures for obtaining automatic consent for accounting method changes, by adding new automatic accounting method changes to the Appendix of Rev. Proc. 2011-14. Also, the automatic accounting method changes to adopt portions of the 2011 temporary regulations are described within Rev. Proc. 2014-16.

**Observation:** Rev. Proc. 2014-16 provides implementing guidance for taxpayers that are adopting the final and 2011 temporary repair regulations for purposes of Sections 162 and 263(a) with respect to amounts paid or incurred for tangible property. The guidance issued under Rev. Proc. 2012-20, which provides procedures to adopt the temporary disposition regulations (Reg. secs. 1.167(a)-4T, 1.168(i)-1T, 1.168(i)-7T, and 1.168(i)-8T) for tax years beginning on or after January 1, 2012, was not affected by Rev. Proc. 2014-16. However, based on the IRS's plan for the final disposition regulations to apply to tax years beginning on or after January 1, 2014, it is expected that the final disposition regulations and related implementing guidance will be issued in the coming weeks.

The new automatic accounting method changes provided by Rev. Proc. 2014-16 contain transition rules for previously filed 2011 temporary repair regulations changes, guidance on filing requirements, Section 481(a) adjustments, and scope limitations. These items and specific repairs method changes are discussed in more detail below.

In addition, Rev. Proc. 2014-16 adds automatic accounting method changes to the Appendix of Rev. Proc. 2011-14

for a change to adopt a reasonable method of allocation of direct and indirect costs under Reg. sec. 1.263A-1(f)(4) and a procedure to reflect changes in capitalized costs for real property acquired by lenders through foreclosure, or similar transaction.

A very important aspect of Rev. Proc. 2014-16 is that the revenue procedure modifies the scope limitations of section 4.02 of Rev. Proc. 2011-14 for certain taxpayers requesting a change in their method of accounting under Rev. Proc. 2011-43, which is the safe harbor method used for determining the amount of expenditures to be capitalized under Section 263(a).

### **Transition rules**

#### **Rev. Proc. 97-27**

Rev. Proc. 2014-16 provides that if before the effective date of the revenue procedure (January 24, 2014), a taxpayer properly filed an application under Rev. Proc. 97-27 requesting consent for an accounting method change described in Rev. Proc. 2014-16 and the application is pending with the IRS National Office, the taxpayer may request to file the method change under Rev. Proc. 2014-16, if otherwise eligible under the revenue procedure. To accomplish this request, the taxpayer must notify the National Office of its intent to make the change under Rev. Proc. 2014-16 prior to the issuance of a letter ruling permitting or denying consent for the change. Upon proper notice by the taxpayer, the National Office will return the Form 3115 to the taxpayer to make necessary modifications and will refund the user fee submitted with the Form 3115.

The Form 3115 will be converted to an application under Rev. Proc. 2014-16 if the taxpayer resubmits the Form 3115 with the necessary modifications. The Form 3115 package also must include a copy of the National Office

letter sent with the returned Form 3115. The Form 3115 package must be returned to the National Office within 30 calendar days of the date listed on the National Office's letter.

#### **Rev. Proc. 2012-19**

If a taxpayer has filed a change under Rev. Proc. 2012-19 and the change was postmarked or received by the IRS on or prior to January 24, 2014, the taxpayer has made a change under Rev. Proc. 2012-19. Rev. Proc. 2014-16 provides taxpayers with the option to file an amended application for that year of change if, by the due date of the federal income tax return (excluding extensions), the taxpayer:

- files an original or amended return using the new method of accounting pursuant to Rev. Proc. 2014-16;
- attaches the original amended application filed under Rev. Proc. 2014-16 to its original or amended return for the year of change;
- provides specific language at the top of page 1 of the Form 3115 being filed in Ogden, Utah; and
- sends the copy of the amended Form 3115 filed with the IRS office in Ogden to the address listed in the revenue procedure no later than the date the original amended application is filed with the original or amended return.

### **Audit protection**

The final repair regulations do not modify the general rule affording audit protection to a taxpayer that voluntarily changes from an improper method of accounting to a method permitted by the regulations. Specifically, a taxpayer that voluntarily changes from an improper to a proper method of accounting receives a commitment from the IRS

that it will not make an examination adjustment relating to the taxpayer's use of the improper method for any prior tax year. Audit protection for changes made under Rev. Proc. 2014-16 begins on the date the Form 3115 is filed with the IRS in Ogden in lieu of the National Office.

### **Single application for two or more concurrent changes**

In general, a taxpayer filing any of the changes in Rev. Proc. 2014-16 for the same identified unit of property (UOP) or, in the case of a building, the same identified building structure or building system, may include all such changes on a single Form 3115. Moreover, a single Section 481(a) adjustment should be provided for all changes related to the identified property.

**Observation:** The new guidance simplifies the filing process by allowing one application for the same UOP. However, taxpayers are required to include the following additional information on line 12 of Form 3115:

- citation of the regulatory section that provides the proposed method(s) of accounting; and
- if changing the UOP or identification of building structure(s) or building system(s), a detailed description of the UOP, building structure(s) or building system(s) used under the current and proposed method of accounting along with citation of regulatory section permitting the proposed method.

Also, Schedule E must be completed for a taxpayer changing its method of accounting to capitalize amounts paid or incurred and to depreciate such property under Sections 167 or 168.

### **New automatic changes**

Rev. Proc. 2014-16 modifies the Appendix of Rev. Proc. 2011-14 to include new automatic method changes. These changes fall into three categories:

- changes under the new section 10.11 of the Appendix to adopt the accounting methods available under the final repair regulations or the 2011 temporary regulations,
- a change under new section 11.09 of the Appendix to adopt a reasonable method of allocation of direct and indirect costs under Reg. sec. 1.263A-1(f)(4), and
- a change under new section 11.10 of the Appendix to reflect changes in capitalized costs for real property acquired by lenders through foreclosure, or similar transaction.

The following provides an analysis of the method changes addressed by Rev. Proc. 2014-16 and the related terms and conditions applicable to each change.

### **Section 10.11 – Adoption of final regulations or 2011 temporary repair regulations**

Section 10.11 incorporates the accounting method changes for a taxpayer making changes under the final repair regulations or, alternatively, the 2011 temporary regulations, into the Appendix of Rev. Proc. 2011-14. Section 10.11 also outlines specific situations that are not covered by the changes set forth in this section. For example, a taxpayer that wants to change its method of accounting for dispositions of depreciable property, including a change in the asset disposed of, would not request permission for such change under section 10.11. Rather, this change would be governed by

other applicable sections of the Appendix of Rev. Proc. 2011-14.

**Observation:** Similar to Rev. Proc. 2012-19, under Rev. Proc. 2014-16 a taxpayer has the option to change from capitalizing under Section 263(a) amounts paid or incurred for tangible property to deducting these amounts as repair and maintenance costs under Section 162. This change also applies to a taxpayer that wishes to change its UOP solely for purposes of determining whether amounts paid or incurred improve a UOP. A taxpayer may need to make either or both of these changes.

**Observation:** Unlike the guidance provided in Rev. Proc. 2012-19, the safe harbor for routine maintenance is not listed as a separate automatic method change under Rev. Proc. 2014-16. However, taxpayers requesting permission to adopt the routine maintenance safe harbor for amounts paid or incurred for routine maintenance on a unit of tangible property would file the change under the automatic method change for amounts paid to improve tangible property (Automatic Change 184).

**Section 481(a) adjustment.** Rev. Proc. 2014-16 conforms to the Section 481(a) requirements in the final repair regulations. Generally, the final repair regulations require a cumulative Section 481(a) adjustment. In addition, Rev. Proc. 2014-16 provides that taxpayers will be able to net positive or negative Section 481(a) adjustments relating to the same identified UOP, or in the case of a building, the same identified building structure or building system.

Rev. Proc. 2014-16 does not modify the Section 481(a) adjustment spread period general rules of Rev. Proc. 2011-14. Thus, a net Section 481(a) adjustment that is a reduction in taxable income is taken into account entirely in the year of change, while a net Section 481(a) adjustment that is

an increase in taxable income is taken into account over four tax years, beginning with the year of change.

With respect to certain items, for example, an accounting method change to deduct non-incidental materials and supplies when used or consumed requires a modified Section 481(a) adjustment. The modified Section 481(a) adjustment takes into account only amounts paid or incurred in tax years beginning on or after January 1, 2014. Accordingly, a taxpayer's existing method of accounting for an item paid or incurred in tax years beginning prior to January 1, 2014, will not be disturbed, and only amounts paid or incurred with respect to the item in tax years beginning on or after January 1, 2014, will be subject to the new method of accounting.

**Note:** A taxpayer that chooses to early adopt the final repair regulations for tax years beginning on or after January 1, 2012, will include amounts paid or incurred beginning on or after the tax year of change (i.e., 2012 or 2013) in its modified Section 481(a) adjustment. Similarly, taxpayers changing to a method of accounting under the 2011 temporary repair regulations that requires a modified Section 481(a) adjustment must take into account only amounts paid or incurred in tax years beginning on or after January 1, 2012, for a year of change beginning on or after January 1, 2012, and ending before January 1, 2014.

**Observation:** Taxpayers that currently use an accounting method that is more favorable for repairs and maintenance expenditures than the accounting method permitted under the final repair regulations will have to recognize income or 'give back' some of the tax benefit via the Section 481(a) adjustment. Likewise, taxpayers that currently use a less favorable accounting method will be

able to claim additional tax deductions.

For all calendar-year taxpayers, the Section 481(a) adjustment for changes in method of accounting made on a modified cutoff basis will be zero. This result is due to the fact that these changes in method are applicable only to amounts paid or incurred in tax years beginning on or after January 1, 2014. Therefore, the taxpayer does not need to look back to the treatment of costs in prior years.

For a list of the accounting method changes, applicable regulatory sections, and the Section 481(a) adjustments (cumulative or modified) under the final and 2011 temporary repair regulations, please see the charts at the end of this Insight.

**Statistical sampling.** If a taxpayer files for an accounting method change that requires a cumulative Section 481(a) adjustment, the taxpayer changing its method of accounting under section 10.11 may use statistical sampling in determining the Section 481(a) adjustment by following the statistical sampling procedures in Rev. Proc. 2011-42.

**Scope limitations.** In general, a taxpayer that is under examination, has engaged in a transaction to which Section 381(a) applies, is in the final year of its trade or business, or has changed its method of accounting for the same item within the past five years may not file an accounting method change under the automatic consent procedures, but instead must file such method change on a non-automatic basis. However, Rev. Proc. 2014-16 waives these 'scope' limitations — contained in section 4.02 of Rev. Proc. 2011-14 — for any tax year beginning before January 1, 2015. Therefore, a taxpayer filing an accounting method change under this revenue procedure during this period has the ability to file any of the new automatic accounting method changes

under the automatic consent procedures.

**Observation:** Rev. Proc. 2012-19 waived these scope limitations for taxpayers filing Form(s) 3115 within a two-year period (i.e., the first or second tax year beginning after December 31, 2011). Rev. Proc. 2014-16 extends this period by waiving the scope limitations for tax years beginning before January 1, 2015. This guidance thus gives taxpayers a three-year window with scope limitations waived to allow taxpayers to analyze their current accounting methods under the final regulations and file the necessary Form(s) 3115.

*Section 11.09 - Adopt a reasonable method under Reg. sec. 1.263A-1(f)(4)*

The final repair regulations clarify that property eligible for certain elections under the final repair regulations (e.g., the de minimis safe harbor) may nonetheless be subject to capitalization under Section 263A (UNICAP) if the amounts paid for the property comprise the direct or allocable indirect costs of other property produced by the taxpayer, or property acquired for resale. For producers, changing the method used to allocate direct or indirect costs historically was a non-automatic method change. Rev. Proc. 2014-16 adds section 11.09 to the Appendix of Rev. Proc. 2011-14 to allow this change to be an automatic method change. This change may be reported on the same Form 3115 used to report changes in method under section 10.11 (discussed above).

**Note:** Rev. Proc. 2014-16 states that "the automatic consent granted under this section is not a determination that the taxpayer's method of allocation has been deemed a reasonable method by the IRS."

**Observation:** Though this automatic change has its limitations, taxpayers now may make this method



change without having to pay a filing fee and wait for advanced consent. Because this change can be filed with the other automatic accounting changes related to repairs, taxpayers now will benefit from the automatic consent procedure. In addition, this automatic change provides taxpayers in the utility industry with the ability to change to one of the reasonable methods addressed in Industry Director Directive (IDD) No. 5 without having to request advanced consent.

### *Section 11.10 – Capitalization of costs to real property acquired through foreclosure*

Section 11.10 applies to a taxpayer that capitalizes costs under Section 263A(b)(2) and Reg. sec. 1.263A-3(a)(1) to real property acquired by lenders through foreclosure or in another similar transaction. The change provides a taxpayer with the ability to change its method of accounting to an otherwise permissible method of accounting under which the acquisition and holding costs for such real property are not capitalized under Section 263A(b)(2) and Reg. sec. 1.263A-3(a)(1). The taxpayer must:

- originate, or acquire and hold for investment, loans that are secured by the real property; and
- acquire the real property that secures the loans at a foreclosure sale, by deed in lieu of foreclosure, or in another similar transaction.

**Observation:** In generic legal advice released February 22, 2013 (GLAM 2013001), the IRS concluded that other real estate owned (OREO) that was acquired by a loan originating bank through foreclosure proceedings or by deed in lieu of foreclosure was not property acquired for resale within the meaning of Section 263A(b)(2). However, historically there was no automatic

change in method procedure to stop capitalizing acquisition and holding costs if the owner of OREO property had adopted an accounting method by previously treating this property as subject to Section 263A(b)(2) for more than one period. As such, the guidance provided by section 11.10 of Rev. Proc. 2014-16 provides taxpayers that are owners of OREO property to change to a permissible method of accounting that does not treat acquisition and holding costs as capitalizable costs.

### **Modified method change: safe harbor under Rev. Proc. 2011-43**

Under the automatic change procedures of Rev. Proc. 2011-14, a taxpayer in the business of transporting, delivering, or selling electricity is allowed to change its method of accounting to the safe harbor under Rev. Proc. 2011-43, for determining the amount of expenditures to be capitalized under Section 263(a). Rev. Proc. 2011-43 provides that the scope limitations of section 4.02 of Rev. Proc. 2011-14 do not apply to a company that changed its method of accounting in its first or second tax year ending after December 30, 2010. Rev. Proc. 2012-39 extended this scope waiver to the third tax year ending after December 30, 2010, and Rev. Proc. 2014-16 extends this scope waiver until the fourth tax year after December 30, 2010.

### **The takeaway**

Rev. Proc. 2014-16 is a critical component in understanding how the final repair regulations will impact any taxpayer that acquires, produces, or improves tangible property. Rev. Proc. 2014-16 presents a more condensed version of the automatic changes for tangible property than the 19 changes listed in Rev. Proc. 2012-19.

The IRS also has simplified the compliance process for taxpayers by allowing a single application to be filed for one or more changes described in Rev. Proc. 2014-16. The revenue procedure also allows taxpayers to net their Section 481(a) adjustments and allows taxpayers to spread a net positive Section 481(a) adjustment over four tax years. The guidance provides taxpayers with the option to early adopt the final repair regulations or adopt the 2011 temporary regulations for tax years that begin prior to January 1, 2014. For tax years beginning on or after January 1, 2014, all taxpayers must comply with the final repair regulations.

### **Resources to help you**

On Wednesday, February 19, PwC will host a webcast, “Tangible property regulations: Practical issues to implementing the final regulations and accounting method procedures.” To register for the webcast, go [here](#).

For an in-depth analysis of the final repair regulations, see WNTS Insight, “[Final tangible property repair regulations: Effective dates, materials and supplies, de minimis rule, and rotatable spare parts](#),” September 18, 2013, WNTS Insight, “[Final tangible property repair regulations: Unit of property and acquisition or improvement of property](#),” September 26, 2013, and WNTS Insight, “[Final repair regulations and proposed regulations: Dispositions, general asset accounts, recovery of certain capital improvements, and removal costs](#),” October 7, 2013.

## **Let's talk**

For a deeper discussion of how this might affect your business, please contact:

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## **Appendix - List of Accounting Method Changes Provided by Rev. Proc. 2014-16**

The charts below provide the applicable accounting method changes under the final and 2011 temporary repair regulations, the designated (automatic) change number (DCN), citation, and whether the change results in a Section 481(a) adjustment or a modified Section 481(a) adjustment.

### **Final Repair Regulations**

DCN	Description of Change	Citation	Section 481(a) Adjustment
184	Deducting repair and maintenance costs, or capitalizing and depreciating improvements to tangible property	Reg. sec. 1.162-4, Reg. sec. 1.263(a)-3	Cumulative Section 481(a) Adjustment
185	Change to the regulatory accounting method	Reg. sec. 1.263(a)-3(m)	Modified Section 481(a) Adjustment
186	Deducting non-incidental materials and supplies when used or consumed	Reg. sec. 1.162-3(a)(1), Reg. sec. 1.162-3(c)(1)	Modified Section 481(a) Adjustment
187	Deducting incidental materials and supplies when paid or incurred	Reg. sec. 1.162-3(a)(2), Reg. sec. 1.162-3(c)(1)	Modified Section 481(a) Adjustment
188	Deducting non-incidental rotatable and temporary spare parts when disposed of	Reg. sec. 1.162-3(a)(3) Reg. sec. 1.162-3(c)(2)	Modified Section 481(a) Adjustment

189	Change to the optional method for rotatable and temporary spare parts	Reg. sec. 1.162-3(e)	Cumulative Section 481(a) Adjustment
190	Change by a dealer in property to deduct commissions and other transaction costs that facilitate the sale of property	Reg. sec. 1.263(a)-1(e)(2)	Cumulative Section 481(a) Adjustment
191	Change by a non-dealer in property to capitalizing commissions and other costs that facilitate the sale of property	Reg. sec. 1.263(a)-1(e)(1)	Cumulative Section 481(a) Adjustment
192	Capitalizing and depreciating acquisition or production costs	Reg. sec. 1.263(a)-2	Cumulative Section 481(a) Adjustment
193	Deducting certain costs for investigating or pursuing the acquisition of real property	Reg. sec. 1.263(a)-2(f)(2)(iii)	Modified Section 481(a) Adjustment

**2011 Temporary Repair Regulations**

DCN	Description of Change	Citation	Section 481(a) Adjustment
162	Deducting repair and maintenance costs, or capitalizing and depreciating improvements to tangible property	Reg. sec. 1.162-4T, Reg. sec. 1.263(a)-3T	Cumulative Section 481(a) Adjustment
163	Change to the regulatory accounting method	Reg. sec. 1.263(a)-3T(k)(2)	Modified Section 481(a) Adjustment
164	Deducting non-incidental materials and supplies when used or consumed	Reg. sec. 1.162-3T(a)(1), Reg. sec. 1.162-3T(c)(1)	Modified Section 481(a) Adjustment
165	Deducting incidental materials and supplies when paid or incurred	Reg. sec. 1.162-3T(a)(2), Reg. sec. 1.162-3T(c)(1)	Modified Section 481(a) Adjustment
166	Deducting non-incidental rotatable and temporary spare parts when disposed of	Reg. sec. 1.162-3T(a)(3) Reg. sec. 1.162-3T(c)(2)	Modified Section 481(a) Adjustment
167	Change to the optional method for rotatable and temporary spare parts	Reg. sec. 1.162-3T(e)	Cumulative Section

			481(a) Adjustment
168	Change by a dealer in property to deduct commissions and other transaction costs that facilitate the sale of property	Reg. sec. 1.263(a)-1T(d)(1)	Cumulative Section 481(a) Adjustment
172	Change by a non-dealer in property to capitalizing commissions and other costs that facilitate the sale of property	Reg. sec. 1.263(a)-1T(d)(1)	Cumulative Section 481(a) Adjustment
173	Capitalizing and depreciating acquisition or production costs	Reg. sec. 1.263(a)-2T	Cumulative Section 481(a) Adjustment
170	Deducting certain costs for investigating or pursuing the acquisition of real property	Reg. sec. 1.263(a)-2T(f)(2)(iii)	Modified Section 481(a) Adjustment
169	Change to applying the de minimis rule	Reg. sec. 1.263(a)-2T(g), Reg. sec. 1.263A-1T(b)(14)	Modified Section 481(a) Adjustment

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